INTERIM STUDY
BY THE
SUBCOMMITTEE ON TAXATION

Montana's State Income Tax

December 1976

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INCOME TAXATION

A REPORT TO THE

FORTY-FIFTH LEGISLATURE

Subcommittee on Taxation

December 1976

Membership
Subcommittee on Taxation

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RECOMMENDATION

The Subcommittee on Taxation recommends:

That the bill to provide a $35 credit against tax liability for each personal exemption presently recognized, in lieu of deducting that exemption from adjusted gross income, be enacted by the 45th Legislature.

INTRODUCTION

Montana first enacted a graduated income tax in 1933. The tax base, i.e., the definitions of adjusted gross income and taxable income, has stood without much change since 1955. Adjusted gross income is whatever it is on the federal tax return, with minor differences in the areas of tax refunds, interest on governmental bonds, and public sector pension benefits. Net taxable income is fairly close to the federal figure -- the itemized deductions are (except for political contributions) the same, while the state's personal exemptions and standard deduction are lower than the figures Congress has enacted. In the lines below net taxable income state and federal computations are quite different, with one set of state rates plus surtax contrasted to four sets of federal rates depending on marital or family status. The tax is the largest single source of state revenue.

House Bill 614 in the 1975 legislature proposed to revise the tax base, applying lower graduated percentages to gross income (including capital gains and municipal bond interest) and substituting credits for the itemized exemptions and deductions. After committee and floor debate in the House, the bill was set aside for this interim study. The "income-splitting" problem -- the effects of Montana's single set of rates and incentive to file separately upon married taxpayers with one source of income -- was not the subject of a bill *per se*, but a number of legislators have pointed out problems in this area in recent years.

The committee on priorities assigned the joint interim subcommittee on taxation to investigate the substance of House Bill 614, 44th Legislature, and also to investigate the problem of income-splitting. The study derived from letters by Speaker Pat McKittrick and House Majority Leader John Driscoll, and by House Taxation Committee Chairman Dan Yardley.

SUBCOMMITTEE DELIBERATIONS

The subcommittee organized itself in the closing days of the 44th Legislature. The first working session was held on June 16, 1975. The income tax division of the department of revenue submitted a memorandum on the administrative aspects of House Bill 614, concluding that a gross income tax could be administered if several technical amendments were made to the bill. The subcommittee requested Council staff research on the rationales behind the various exclusions and deductions in the federal income tax.

A research report was prepared for the subcommittee's next session on November 3, 1975. Several witnesses also testified on the concept of a gross income tax. The subcommittee decided to continue study of three aspects of House Bill 614 (personal credits, and treating public retirement benefits and municipal bond interest as taxable income) and to drop consideration of the rest of the bill.

At the next meeting, April 23, 1976, the subcommittee received additional research on these three points. The decision was made to draw up a bill on the personal credit; no further action was taken on the public retirement or municipal bond interest issues. The subcommittee also began general discussion of the income-splitting problem at this meeting, and requested the department to draw up alternative sets of rate tables which would favor joint husband-wife returns.

On June 11, 1976, the subcommittee approved the text of the personal credit bill while withholding decision on the dollar amount of the credit. The September 2 meeting included a short discussion of the department's tables for joint returns and clarification of the subcommittee's request to the department.

At the subcommittee's final meeting on October 1, 1976, the decisions were to peg the personal credit at $35, and to publish the department's revised alternative rate tables without recommendation. The personal credit bill is Appendix A to this report and the alternative rate tables prepared by the department follow as Appendix B. The staff research on reasons for the various exclusions and deductions is Appendix C.

FINDINGS AND RECOMMENDATIONS

The subcommittee finds that the personal and dependents exemptions provision, section 84-4910 in the state income tax chapter, does not mitigate tax burdens in the best way. This is a consequence of the progressive rate structure in our income tax. To a taxpayer whose income on December 31 hits the 10% bracket, i.e., $35,000 taxable income for the year, his dependent child reduces his taxes by $65. To a taxpayer who has taxable income of $6,000 a year (earning perhaps between $8,000 and $9,000), his dependent child reduces his tax bill by $32.50, for this taxpayer ends up in the 5% bracket.

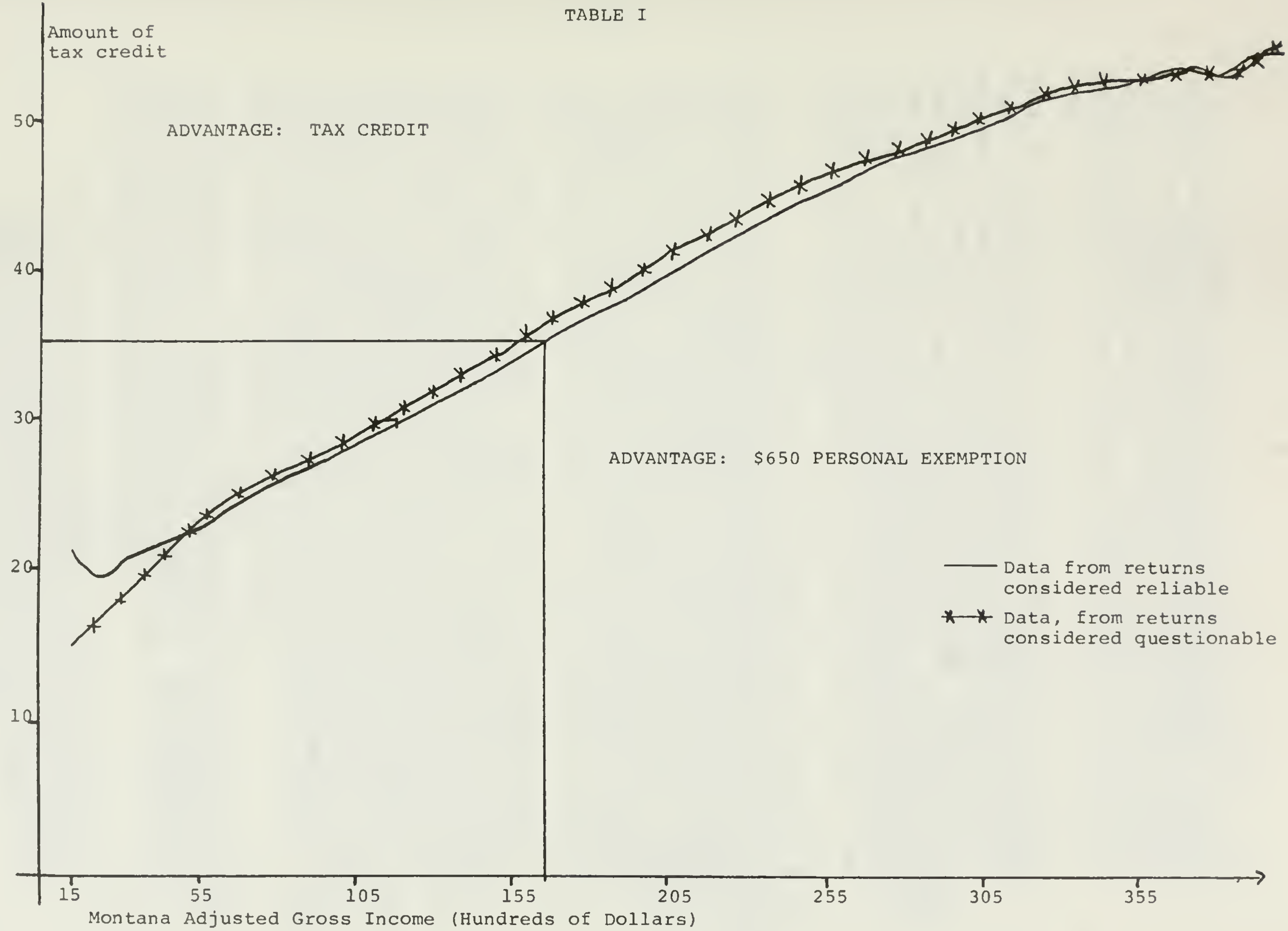
The subcommittee assumes that the rationale behind the exemptions is that to a degree the most basic costs of maintaining a dependent should not be taxed. Those most basic outlays, for food, clothing, and shelter, are relatively inflexible, they do not increase in proportion to increases in total income. The subcommittee therefore concluded that the tax break for every dependent, and for the personal exemption, should be the same on the bottom line. $35 was selected as the revenue-neutral point for this credit: at a lower level the state would gain revenue and vice versa.

To illustrate the change, take a taxpayer who last year took four exemptions -- the personal exemption, one for the spouse, and one each for two children. Last year the four exemptions reduced total income by $2,600 (4 x $650) to work down toward taxable income. Under the subcommittee proposal, this family's taxable income would be $2,600 higher. However, after the tax bill was calculated as a percentage of this taxable income, $140 (4 x $35) would be subtracted from the tax bill to reach the bottom line.

A mathematical comparison of the present exemptions to the proposed credits is expressed in Table 1. The vertical line is the amount of the tax credit and a horizontal line drawn across to the curve shows where the credit is more advantageous than the $650 personal exemption and where it becomes less advantageous. A $35 credit benefits every taxpayer having adjusted gross income of $16,000 or less.

As to the remainder of House Bill 614, the subcommittee found its treatment of capital gains (essentially treated as 100% ordinary income in the year when realized) to be a fatal flaw The problem is that the progressive rate structure would treat the entire capital gain as that year's income and tax it at a higher rate. This does not recognize the preceding years' contributions to the increased value. The taxpayer who sells

TABLE I


Amount of tax credit
50
40
30
20
10
ADVANTAGE: TAX CREDIT
ADVANTAGE: $650 PERSONAL EXEMPTION
Data from returns considered reliable
Data, from returns considered questionable
15
55
105
155
205
255
305
355
Montana Adjusted Gross Income (Hundreds of Dollars)

a home, business or ranch after 20 years of building it up should not have the appreciation in value taxed at the same rate as a taxpayer who wins the Irish Sweepstakes. For a fuller discussion of this problem, see the staff research report to the subcommittee, "Justifications for Exclusions and Deductions in the Internal Revenue Code," attached as Appendix C.

The tax-exempt status of interest on state and municipal bonds was considered at some further length by the subcommittee. However, this is an issue with more impact in the area of taxes on the income of corporations than in the individual income tax. Corporation tax matters were outside the subcommittee's interim study mandate. It does not appear feasible to curtail the exemptions of various types of public employee retirement benefits, primarily because of court decisions giving the exemption the status of a contractual obligation of the state.

The second major area which the subcommittee was directed to consider was income-splitting between husband and wife. Unlike the Internal Revenue Code with its four sets of rates (married-joint, married-filing separately, single-head of household, and single), the state income tax has but one set of rates for all taxpayers. Since the tax bill on $20,000 of taxable income is $1,439, while the bill for $10,000 taxable income is $539, a husband and wife who each earn $10,000 taxable income will always file separate state returns -- they save $407 over what they would owe on a joint return on $20,000.

The problem arises when husband and wife together work a ranch or farm or small business and together earn $20,000 taxable income by their efforts. The department of revenue interprets the present law as not allowing this couple to split their income half-and-half on their state tax returns. Rather, the department's regulation allows the couple to pretend that the spouse who is the proprietor pays the other reasonable wages for services actually contributed to the business (Montana Administrative Code, Rule 42-2.8(1)-S8660). The prevailing rate for farm labor, which has been the "reasonable wages" allowed on the returns of some farm wives, may fall far short of half the family income.

The subcommittee requested the department of revenue to draw up sets of rate schedules to make filing the joint return more advantageous for married taxpayers. The department went through five sets and found that one or another of the following problems always appeared:

(1) If we keep single taxpayers' liability where it is now and cut the married-filing-jointly rate until it is advantageous for nearly all couples, the revenue loss to the state is too large ($8 million to $11 million per year);

(2) If we design an advantageous joint rate within the limits of a modest revenue loss ($3 million to $4 million), the taxes of single persons generally have to go up;

(3) If we go to simple income-splitting for joint returns relative to single returns, the rate differential, like the federal rates from 1948 to 1971, discriminates against single persons;

(4) If we follow the rate relationships of the current federal tables, where the second table sets significantly higher rates for marrieds-filing-separately (with rates for singles falling in between), and avoid the major revenue loss, taxes will go up for many married taxpayers in Montana with separate incomes.

In short, there appears to be no way to move from where we are to another position without either increasing taxes on some groups or incurring substantial revenue loss. The subcommittee therefore makes no recommendation for adopting a joint return rate schedule. For the information of members of the 45th Legislature, Appendix B presents a set of rates which shift $8 million of the income burden from married taxpayers with one joint income and from single taxpayers to the married taxpayers with separate incomes.

A P P E N D I C E S

APPENDIX A

PERSONAL CREDIT BILL

__________ BILL NO. _____

INTRODUCED BY ____

A BILL FOR AN ACT ENTITLED: "AN ACT TO CONVERT THE PERSONAL EXEMPTIONS UNDER THE INCOME TAX INTO CREDITS AGAINST INCOME TAX LIABILITY; AMENDING 84-4910, R.C.M. 1947; AND PROVIDING AN EFFECTIVE DATE."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF MONTANA:

Section 1. Section 84-4910, R.C.M. 1947, is amended to read as follows:

"84-4910. ~~Exemptions~~ Dependency credits. (1)~~(a)--Allowance--of--Personal-Exemption.~~ In the case of an individual, the ~~exemptions-provided~~ dependency relationships recognized under ~~by~~ this section shall be allowed as ~~deductions--in--computing-taxable-income~~ credits against tax liability. Each credit to which the taxpayer is entitled shall reduce the final tax liability determined under 84-4902 and 84-4902.1 by $35. Total credits claimed may not exceed income tax liability for the year as determined prior to the credits allowed under 84-3514 and 84-4937.

~~(b)~~(2) ~~Taxpayer--and--Spouse.--An--exemption--of---six hundred--fifty--dollars--($650)~~ One credit shall be allowed for taxable years beginning after December 31, ~~1973~~ 1976, for the taxpayer~~;~~, and an additional ~~exemption--of-six~~

~~hundred-fifty-dollars-($650)~~ credit shall be allowed for taxable years beginning after December 31, ~~1973~~ 1976, for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

~~(c)~~(3) (a) ~~Additional-Exemption-for-Taxpayer-or-Spouse-Aged-Sixty-five-(65)-or-More.-(1)-For-taxpayer.~~ An additional ~~exemption--of--six-hundred-fifty-dollars-($650)~~ credit shall be allowed for taxable years beginning after December 31, ~~1973~~ 1976, for the taxpayer if he has attained the age of ~~sixty-five-(65)~~ before the close of his taxable year.

~~(2)~~(b) ~~For-spouse.~~ An additional ~~exemption--of--six-hundred--fifty--dollars--($650)~~ credit shall be allowed for taxable years beginning after December 31, ~~1973~~ 1976, for the spouse of the taxpayer if a separate return is made by the taxpayer, and if the spouse has attained the age of ~~sixty-five--(65)~~ before the close of such taxable year and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

~~(d)~~(4) (a) ~~Additional--Exemption--for---Blindness---of-Taxpayer---or---Spouse.--(1)--For--taxpayer.~~ An additional ~~exemption-of-six-hundred-fifty-dollars-($650)~~ credit shall be allowed for taxable years beginning after December 31,

~~1973~~ 1976, for the taxpayer if he is blind at the close of his taxable year.

~~(2)~~(b) ~~For--spouse.~~ An additional ~~exemption--of-six hundred-fifty-dollars-($650)~~ credit shall be allowed for taxable years beginning after December 31, ~~1973~~ 1976, for the spouse of the taxpayer if a separate return is made by the taxpayer and if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. For the purposes of this ~~paragraph~~ subsection, the determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer~~;~~, except that if the spouse dies during such taxable year such determination shall be made as of the time of such death.

~~(3)~~(c) ~~Blindness---defined.~~ For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses~~,~~ or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

~~(c)~~(5) (a) ~~Additional---Exemption---for---Dependents.~~ ~~(1)--In-general.--An-exemption-of-six-hundred-fifty--dollars ($650)~~ A credit shall be allowed for taxable years beginning

after December 31, ~~1973~~ 1976, for each dependent:

~~(A)~~(i) ~~Whose~~ whose gross income for the calendar year in which the taxable year of the taxpayer begins is less than ~~six--hundred-fifty-dollars-($650)~~; ~~shall-be allowed-for-taxable-years-beginning-after-December--31, 1973,~~ or

~~(B)~~(ii) ~~Who~~ who is a child of the taxpayer and who:

~~(i)~~(A) has not attained the age of ~~nineteen-(19)~~ years at the close of the calendar year in which the taxable year of the taxpayer begins~~,~~; or

~~(ii)~~(B) is a student.

~~(2)~~(b) ~~Exemption--denied--in--case--of-certain-married dependents.~~ No ~~exemption-shall~~ credit may be allowed under this subsection for any dependent who has made a joint return with his spouse for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

~~(3)~~(c) ~~Child--defined.~~ For purposes of ~~paragraph-(1) (B)~~ subsection (5)(a)(ii), the term "child" means an individual who is a son, stepson, daughter, or stepdaughter of the taxpayer.

~~(4)~~(d) ~~Student-and--educational--institution--defined.~~ For purposes of ~~paragraph---(1)--(B)--(ii)~~ subsection (5)(a)(ii)(B), the term "student" means an individual who during each of ~~five-(5)~~ calendar months during the calendar

year in which the taxable year of the taxpayer begins~~,~~:

~~(A)~~ (i) ~~is~~ is a full-time student at an educational institution; or

~~(B)~~ (ii) ~~is~~ is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a state or political subdivision of a state. For purposes of this ~~paragraph~~ subsection, the term "educational institution" means only an educational institution which normally maintains a regular faculty and curriculum and normally has a regularly organized body of students in attendance at the place where its educational activities are carried on.

~~(f)~~(6) ~~General--Definition.~~ For purposes of this section, the term "dependent" means any of the following individuals over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer:

~~(1)~~(a) ~~A~~ a son or daughter of the taxpayer~~,~~ or a descendant of either~~,~~;

~~(2)~~(b) ~~A~~ a stepson or stepdaughter of the taxpayer~~,~~;

~~(3)~~(c) ~~A~~ a brother, sister, stepbrother, or stepsister of the taxpayer~~,~~;

~~(4)~~(d) ~~The~~ the father or mother of the taxpayer~~,~~ or an ancestor of either~~,~~;

~~(5)~~(e) ~~A~~ a stepfather or stepmother of the taxpayer~~,~~;

~~(6)~~(f) ~~A~~ a son or daughter of a brother or sister of the taxpayer~~,~~;

~~(7)~~(g) ~~A~~ a brother or sister of the father or mother of the taxpayer~~,~~;

~~(8)~~(h) ~~A~~ a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer~~,~~;

~~(9)~~(i) ~~An~~ an individual who, for the taxable year of the taxpayer, has as his principal place of abode the home of the taxpayer, and is a member of the taxpayer's household~~,~~; or

~~(10)~~(j) ~~An~~ an individual who:

~~(A)~~(i) is a descendant of a brother or sister of the father or mother of the taxpayer~~,~~;

~~(B)~~(ii) for the taxable year of the taxpayer, received institutional care required by reason of a physical or mental disability~~,~~; and

~~(C)~~(iii) before receiving such institutional care, was a member of the same household as the taxpayer.

~~(a)~~(7) ~~Rules---Relating--to--General--Definition.~~ For purposes of this section:

~~(1)~~(a) ~~The~~ the terms "brother" and "sister" include a brother or sister by the half blood~~,~~;

~~(2)~~(b) ~~In-determining-whether-any-of-the-relationships~~

~~specified--in--subsection--(a)--or--paragraph--(1)--of--this subsection-exists,~~ a legally adopted child of an individual shall be treated as a child of such individual by blood.

~~(h)~~(8) ~~Determination--of--Marital-Status.~~ For purposes of this ~~part~~ chapter:

~~(1)--The~~ (a) the determination of whether an individual is married shall be made as of the close of his taxable year~~;~~, except that if his spouse dies during his taxable year such determination shall be made as of the time of such death; and

~~(2)--An~~ (b) an individual legally separated from his spouse under a decree of divorce or of separate maintenance shall not be considered as married.

~~(i)~~(9) ~~Proration-of-exemption-deduction-in~~ In the case of a nonresident taxpayer, ~~(1)--The-exemption-deduction~~ the credit shall be prorated according to the ratio the taxpayer's Montana adjusted gross income bears to his federal adjusted gross income."

Section 2. Effective date. This act is effective upon passage and approval.

-End-

APPENDIX B

ALTERNATIVE RATE TABLES

STATE OF MONTANA
DEPARTMENT OF REVENUE
MITCHELL BUILDING
HELENA, MONTANA 59601

NOVEMBER 19, 1976

MEMORANDUM

TO: Interim Subcommittee on Taxation

FROM: John M. Clark, Administrator, Research Division JMC

SUBJECT: Proposed Income Tax Rate Schedules

The Research Division analysis of the income tax returns of married couples who file separately yielded the following results.

Total number of returns	345,674	
Number of joint returns	105,212	
Number of single individual returns	121,748	
Number of married-separate returns	118,714	
Separate same form		112,676
Separate different forms		3,691
Separate one spouse not filing		2,347

Thus, there are 56,338 married couples having two incomes about whom we have information as to household income. The distribution of joint incomes tends, as one would expect, to be skewed toward much higher values than one finds among households with single income sources.

Joint Montana Adjusted Gross Income: At Least	But Less Than	Number of Couples
-	0	89
0	5000	2092
5000	6000	1133
6000	7000	1442
7000	8000	1517
8000	9000	1697
9000	10000	1967
10000	11000	2297
11000	12000	2356
12000	13000	2631
13000	14000	2764
14000	15000	2975
15000	16000	3109

Joint Montana Adjusted Gross Income		
At Least	But Less Than	Number of Couples
16000	17000	3180
17000	18000	3063
18000	19000	2918
19000	20000	2670
20000	21000	2410
21000	22000	2014
22000	23000	1752
23000	24000	1553
24000	25000	1299
25000	26000	1067
26000	27000	994
27000	28000	771
28000	29000	638
29000	30000	563
30000	31000	476
31000	32000	407
32000	33000	351
33000	34000	307
34000	35000	279
35000	50000	2066
50000		1489

The accompanying histogram (fig. 1) illustrates this distribution.

There are really two problems. First, because of Montana's single rate table, those married couples who have two incomes and, thus, may file separate returns pay at a lower effective tax rate. The following table illustrates this fact.

	(A) Total Mt Adjusted Gross Income	(B) Total Tax Paid	Effective Tax Rate B÷A
Joint	1,114,365,884	41,032,529	.03682
Separate	1,065,957,624	36,189,730	.03395

The effective tax rate for couples who file separately is 7.79% lower than that for couples who file jointly.

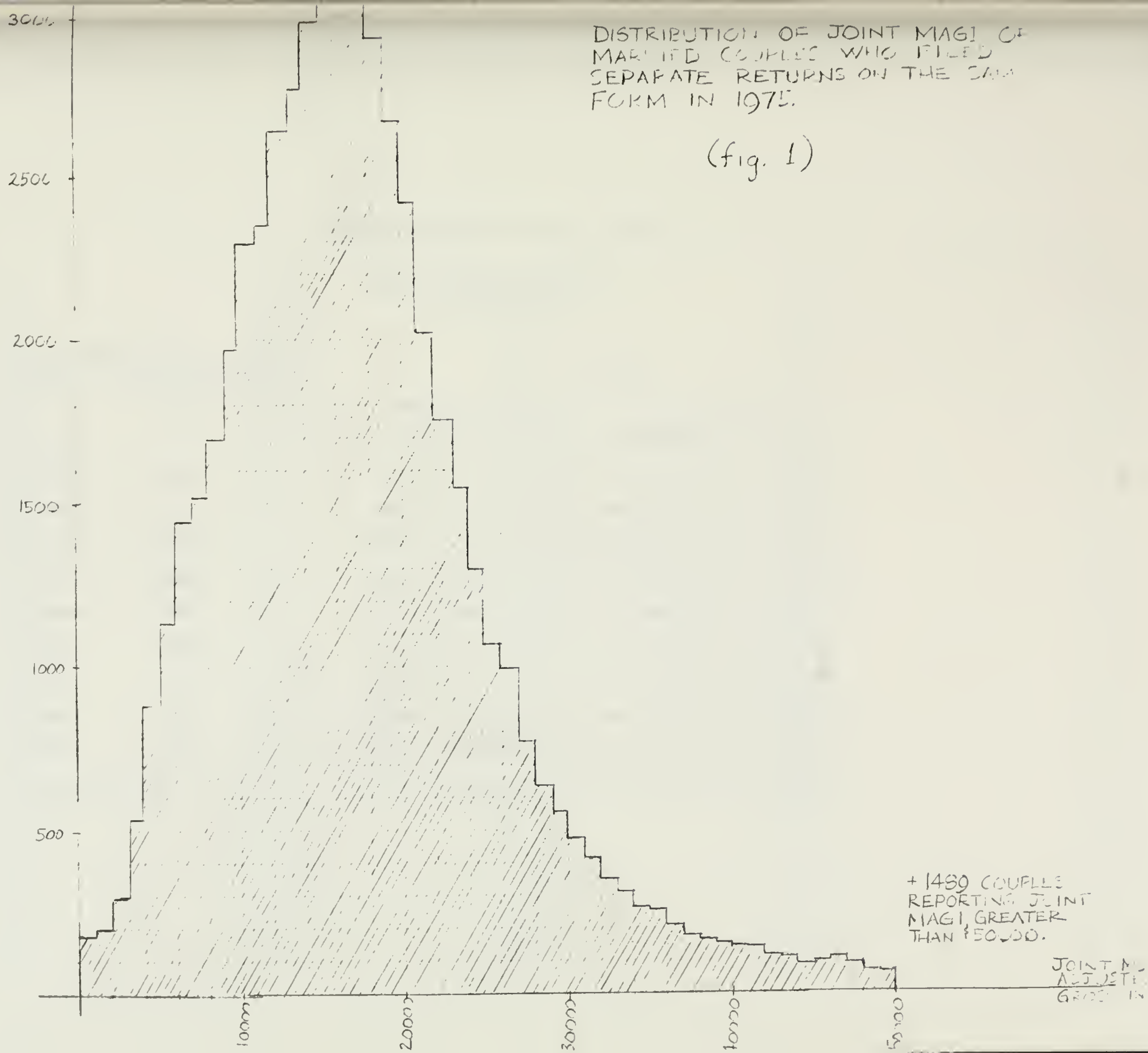
Second, the ability to file separately has undoubtably led to certain practices relative to allocating deductions and exemptions, which, while probably legal in the majority of cases, are certainly outside the spirit of the income tax law. The following table shows the distribution of differences between taxable incomes reported by married couples who filed separately.

Difference In Taxable Income Reported On Separate Returns		Number Of Couples	Proportion Of Total Number Of Couples
At Least	But Less Than		
0	1000	14729	.2614
1000	2000	7542	.1338
2000	3000	5952	.1056
3000	4000	5223	.0927
4000	5000	4351	.0772
5000	6000	3797	.0674
6000	7000	3018	.0536
7000	8000	2499	.0444
8000	9000	1749	.0310
9000	10000	1379	.0245
10000		6102	.1083

For example, 7542 married couples reported separate taxable incomes where the difference between the taxable incomes of husband and wife was at least $1000 but less than $2000. The fact that over 50% of the couples report a difference in their taxable incomes of less than $3000 indicates that most have correctly determined that the way to minimize state income tax liability is to make their two taxable incomes as nearly equal as possible.

If the married couples who currently file separately on the same return were required to pool their incomes and file jointly the state would have realized an increase in income tax collection of a little more than $8 million in 1975.

From the standpoint of simple equity it appears that some sort of action ought to be taken. The simplest course would be to institute a set of rate tables. The accompanying set of tables is designed to eliminate the disparity which exists between households which have one wage earner and those which have more than one. In essence it decreases the taxes of those who have been filing jointly and those who file as single individuals. The revenue loss is to be made up by those who have been able to file separately in the past <u>but</u> will no longer find it advantageous to do so. The net revenue impact ought to be nearly zero. (Of course, the latter statement anticipates that the ten percent surtax will be kept.)



DISTRIBUTION OF JOINT MAGI OF MARRIED COUPLES WHO FILED SEPARATE RETURNS ON THE SAM FORM IN 1975.

(fig. 1)

PROPOSED INCOME TAX RATE SCHEDULE

MARRIED--FILING JOINTLY
SURTAX 10 %

TAXABLE INCOME AT LEAST	BUT LESS THAN	TAX RATE
$ 0	$ 1200	$ .00 PLUS 2.0 % OF THE EXCESS OVER $ 0
$ 1200	$ 2400	$ 24.00 PLUS 3.0 % OF THE EXCESS OVER $ 1200
$ 2400	$ 4800	$ 60.00 PLUS 4.0 % OF THE EXCESS OVER $ 2400
$ 4800	$ 7200	$ 156.00 PLUS 5.0 % OF THE EXCESS OVER $ 4800
$ 7200	$ 9600	$ 276.00 PLUS 6.0 % OF THE EXCESS OVER $ 7200
$ 9600	$ 12000	$ 420.00 PLUS 7.0 % OF THE EXCESS OVER $ 9600
$ 12000	$ 17000	$ 588.00 PLUS 8.0 % OF THE EXCESS OVER $ 12000
$ 17000	$ 23000	$ 988.00 PLUS 9.0 % OF THE EXCESS OVER $ 17000
$ 23000	$ 29000	$ 1528.00 PLUS 9.5 % OF THE EXCESS OVER $ 23000
$ 29000	$ 35000	$ 2098.00 PLUS 10.0 % OF THE EXCESS OVER $ 29000
$ 35000	$ 42000	$ 2698.00 PLUS 10.5 % OF THE EXCESS OVER $ 35000
$ 42000 AND OVER		$ 3433.00 PLUS 11.0 % OF THE EXCESS OVER $ 42000

MARRIED - FILING JOINTLY

COMPARISON OF LIABILITY UNDER PROPOSED SCHEDULE WITH LIABILITY UNDER CURRENT SCHEDULE

TAXABLE INCOME	LIABILITY (CURRENT)	LIABILITY (PROPOSED)	ABSOLUTE DIFFERENCE	PERCENT DIFFERENCE
500	11.00	11.00	.00	.00
1500.	38.50	36.30	-2.20	-5.71
2500.	77.00	70.40	-6.60	-8.57
3500.	121.00	114.40	-6.60	-5.45
4500.	170.50	158.40	-12.10	-7.10
5500.	225.50	210.10	-15.40	-6.83
6500.	286.00	265.10	-20.90	-7.31
7500.	352.00	323.40	-28.60	-8.13
8500.	423.50	389.40	-34.10	-8.05
9500.	500.50	455.40	-45.10	-9.01
10500.	583.00	531.30	-51.70	-8.87
11500.	671.00	608.30	-62.70	-9.34
12500.	759.00	690.80	-68.20	-8.99
13500.	847.00	778.80	-68.20	-8.05
14500.	940.50	866.80	-73.70	-7.84
15500.	1039.50	954.80	-84.70	-8.15
16500.	1138.50	1042.80	-95.70	-8.41
17500.	1237.50	1136.30	-101.20	-8.18
18500.	1336.50	1235.30	-101.20	-7.57
19500.	1435.50	1334.30	-101.20	-7.05
20500.	1540.00	1433.30	-106.70	-6.93
21500.	1650.00	1532.30	-117.70	-7.13
22500.	1760.00	1631.30	-128.70	-7.31
23500.	1870.00	1733.05	-136.95	-7.32
24500.	1980.00	1837.55	-142.45	-7.19
25500.	2090.00	1942.05	-147.95	-7.08
26500.	2200.00	2046.55	-153.45	-6.98
27500.	2310.00	2151.05	-158.95	-6.88
28500.	2420.00	2255.55	-164.45	-6.80
29500.	2530.00	2362.80	-167.20	-6.61
30500.	2640.00	2472.80	-167.20	-6.33
31500.	2750.00	2582.80	-167.20	-6.08
32500.	2860.00	2692.80	-167.20	-5.85
33500.	2970.00	2802.80	-167.20	-5.63
34500.	3080.00	2912.80	-167.20	-5.43
35500.	3195.50	3025.55	-169.95	-5.32
36500.	3316.50	3141.05	-175.45	-5.29
37500.	3437.50	3256.55	-180.95	-5.26
38500.	3558.50	3372.05	-186.45	-5.24
39500.	3679.50	3487.55	-191.95	-5.22
40500.	3800.50	3603.05	-197.45	-5.20

PROPOSED INCOME TAX RATE SCHEDULE

MARRIED--FILING SEPARATELY

SURTAX 10 %

TAXABLE INCOME AT LEAST	BUT LESS THAN	TAX RATE
\$ 0	\$ 600	\$ .00 PLUS 2.0 % OF THE EXCESS OVER \$ 0
\$ 600	\$ 1200	\$ 12.00 PLUS 3.0 % OF THE EXCESS OVER \$ 600
\$ 1200	\$ 2400	\$ 30.00 PLUS 4.0 % OF THE EXCESS OVER \$ 1200
\$ 2400	\$ 3600	\$ 78.00 PLUS 5.0 % OF THE EXCESS OVER \$ 2400
\$ 3600	\$ 4800	\$ 138.00 PLUS 6.0 % OF THE EXCESS OVER \$ 3600
\$ 4800	\$ 6000	\$ 210.00 PLUS 7.0 % OF THE EXCESS OVER \$ 4800
\$ 6000	\$ 8500	\$ 294.00 PLUS 8.0 % OF THE EXCESS OVER \$ 6000
\$ 8500	\$ 11500	\$ 494.00 PLUS 9.0 % OF THE EXCESS OVER \$ 8500
\$ 11500	\$ 14500	\$ 764.00 PLUS 9.5 % OF THE EXCESS OVER \$ 11500
\$ 14500	\$ 17500	\$ 1049.00 PLUS 10.0 % OF THE EXCESS OVER \$ 14500
\$ 17500	\$ 21000	\$ 1349.00 PLUS 10.5 % OF THE EXCESS OVER \$ 17500
\$ 21000 AND OVER		\$ 1716.50 PLUS 11.0 % OF THE EXCESS OVER \$ 21000

ASSUMES THAT TAXPAYERS WERE ABLE TO ACHIEVE A 50-50 SPLIT UNDER CURRENT LAW

COMPARISON OF LIABILITY UNDER PROPOSED SCHEDULE WITH LIABILITY UNDER CURRENT SCHEDULE

TAXABLE INCOME	LIABILITY (CURRENT)	LIABILITY (PROPOSED)	ABSOLUTE DIFFERENCE	PERCENT DIFFERENCE
500.	11.00	11.00	.00	.00
1500.	33.00	36.30	3.30	10.00
2500.	60.50	70.40	9.90	16.36
3500.	93.50	114.40	20.90	22.35
4500.	132.00	158.40	26.40	20.00
5500.	176.00	210.10	34.10	19.38
6500.	220.00	265.10	45.10	20.50
7500.	264.00	323.40	59.40	22.50
8500.	313.50	389.40	75.90	24.21
9500.	368.50	455.40	86.90	23.58
10500.	423.50	531.30	107.80	25.45
11500.	478.50	608.30	129.80	27.13
12500.	539.00	690.80	151.80	28.16
13500.	605.00	778.80	173.80	28.73
14500.	671.00	866.80	195.80	29.18
15500.	737.00	954.80	217.80	29.55
16500.	808.50	1042.80	234.30	28.98
17500.	885.50	1136.30	250.80	28.32
18500.	962.50	1235.30	272.80	28.34
19500.	1039.50	1334.30	294.80	28.36
20500.	1122.00	1433.30	311.30	27.75
21500.	1210.00	1532.30	322.30	26.64
22500.	1298.00	1631.30	333.30	25.68
23500.	1386.00	1733.05	347.05	25.04
24500.	1474.00	1837.55	363.55	24.66
25500.	1562.00	1942.05	380.05	24.33
26500.	1650.00	2046.55	396.55	24.03
27500.	1738.00	2151.05	413.05	23.77
28500.	1831.50	2255.55	424.05	23.15
29500.	1930.50	2362.80	432.30	22.39
30500.	2029.50	2472.80	443.30	21.84
31500.	2128.50	2582.80	454.30	21.34
32500.	2227.50	2692.80	465.30	20.89
33500.	2326.50	2802.80	476.30	20.47
34500.	2425.50	2912.80	487.30	20.09
35500.	2524.50	3025.55	501.05	19.85
36500.	2623.50	3141.05	517.55	19.73
37500.	2722.50	3256.55	534.05	19.62
38500.	2821.50	3372.05	550.55	19.51
39500.	2920.50	3487.55	567.05	19.42
40500.	3025.00	3603.05	578.05	19.11

PROPOSED INCOME TAX RATE SCHEDULE

SINGLE--SINGLE HEAD OF HOUSEHOLD
SURTAX 10 %

TAXABLE INCOME AT LEAST	BUT LESS THAN	TAX RATE
$ 0	$ 1000	$ .00 PLUS 2.0 % OF THE EXCESS OVER $ 0
$ 1000	$ 2200	$ 20.00 PLUS 3.0 % OF THE EXCESS OVER $ 1000
$ 2200	$ 4400	$ 56.00 PLUS 4.0 % OF THE EXCESS OVER $ 2200
$ 4400	$ 6600	$ 144.00 PLUS 5.0 % OF THE EXCESS OVER $ 4400
$ 6600	$ 8800	$ 254.00 PLUS 6.0 % OF THE EXCESS OVER $ 6600
$ 8800	$ 10800	$ 386.00 PLUS 7.0 % OF THE EXCESS OVER $ 8800
$ 10800	$ 15000	$ 526.00 PLUS 8.0 % OF THE EXCESS OVER $ 10800
$ 15000	$ 20000	$ 862.00 PLUS 9.0 % OF THE EXCESS OVER $ 15000
$ 20000	$ 26000	$ 1312.00 PLUS 9.5 % OF THE EXCESS OVER $ 20000
$ 26000	$ 32000	$ 1882.00 PLUS 10.0 % OF THE EXCESS OVER $ 26000
$ 32000	$ 38000	$ 2482.00 PLUS 10.5 % OF THE EXCESS OVER $ 32000
$ 38000 AND OVER		$ 3112.00 PLUS 11.0 % OF THE EXCESS OVER $ 38000

Single -

COMPARISON OF LIABILITY UNDER PROPOSED SCHEDULE WITH LIABILITY UNDER CURRENT SCHEDULE

TAXABLE INCOME	LIABILITY (CURRENT)	LIABILITY (PROPOSED)	ABSOLUTE DIFFERENCE	PERCENT DIFFERENCE
500.	11.00	11.00	.00	.00
1500.	38.50	38.50	.00	.00
2500.	77.00	74.80	-2.20	-2.86
3500.	121.00	118.80	-2.20	-1.82
4500.	170.50	163.90	-6.60	-3.87
5500.	225.50	218.90	-6.60	-2.93
6500.	286.00	273.90	-12.10	-4.23
7500.	352.00	338.80	-13.20	-3.75
8500.	423.50	404.80	-18.70	-4.42
9500.	500.50	478.50	-22.00	-4.40
10500.	583.00	555.50	-27.50	-4.72
11500.	671.00	640.20	-30.80	-4.59
12500.	759.00	728.20	-30.80	-4.06
13500.	847.00	816.20	-30.80	-3.64
14500.	940.50	904.20	-36.30	-3.86
15500.	1039.50	997.70	-41.80	-4.02
16500.	1138.50	1096.70	-41.80	-3.67
17500.	1237.50	1195.70	-41.80	-3.38
18500.	1336.50	1294.70	-41.80	-3.13
19500.	1435.50	1393.70	-41.80	-2.91
20500.	1540.00	1495.45	-44.55	-2.89
21500.	1650.00	1599.95	-50.05	-3.03
22500.	1760.00	1704.45	-55.55	-3.16
23500.	1870.00	1808.95	-61.05	-3.26
24500.	1980.00	1913.45	-66.55	-3.36
25500.	2090.00	2017.95	-72.05	-3.45
26500.	2200.00	2125.20	-74.80	-3.40
27500.	2310.00	2235.20	-74.80	-3.24
28500.	2420.00	2345.20	-74.80	-3.09
29500.	2530.00	2455.20	-74.80	-2.96
30500.	2640.00	2565.20	-74.80	-2.83
31500.	2750.00	2675.20	-74.80	-2.72
32500.	2860.00	2787.95	-72.05	-2.52
33500.	2970.00	2903.45	-66.55	-2.24
34500.	3080.00	3018.95	-61.05	-1.98
35500.	3195.50	3134.45	-61.05	-1.91
36500.	3316.50	3249.95	-66.55	-2.01
37500.	3437.50	3365.45	-72.05	-2.10
38500.	3558.50	3483.70	-74.80	-2.10
39500.	3679.50	3604.70	-74.80	-2.03
40500.	3800.50	3725.70	-74.80	-1.97

APPENDIX C

STAFF RESEARCH ON EXCLUSIONS AND DEDUCTIONS

JUSTIFICATIONS FOR EXCLUSIONS AND DEDUCTIONS IN THE INTERNAL REVENUE CODE (Personal Income Tax)

Report to the Subcommittee on Taxation
by Roger Tippy, Staff Attorney
October, 1975

ABSTRACT

The average theoretical rate of federal income tax is about 25% while the average actual rate people pay is just over 10% of their total monetary income. The 15% difference between theory and fact comes about through personal exemptions (7%), itemized deductions (5%), income splitting by husband and wife (1.7%) and exclusion of certain types of income from adjusted gross income (1.3%). This report examines the justifications for the principal exclusions and itemized deductions.

INTRODUCTION

The structure of Montana's personal income tax is based upon federal tax law and is lifted from that source by reference to a few key sections of the Internal Revenue Code. As a result, whenever Congress adds another exclusion or deduction, the same feature automatically appears in the Montana income tax, without action by the legislature. Thus, the rationales or justifications for many of the forms of favored tax treatment are known in Congress but have never been debated in Helena.

The subcommittee, at its June meeting, requested a research report on the reasons given for the various deductions and exclusions in the Internal Revenue Code. Reasons have been adduced from committee reports of the House Ways and Means and Senate Finance

committees, where available, and books dealing with the income tax structure where Congressional explanations were unavailable. Books consulted were:

Pechman, Joseph A., Federal Tax Policy (1971). An economist at the Brookings Institution, Pechman is generally in favor of the structure of the income tax, but is critical of a number of the specific deductions.

Hellerstein, Jerome R., Taxes, Loopholes and Morals (1963). The author practices and teaches tax law in New York City; like Pechman, he writes in a cool objective tone and seems to say that tinkering with a few things would make a pretty good machine run even better.

Stern, Philip M., The Rape of the Taxpayer (1973). An update of the same author's Great Treasury Raid published in 1964, and full of wrath against the wealthy who are taking advantage of tax loopholes to grow even wealthier.

Buckley, William F., Jr., Four Reforms (1973). That some are wealthier than others does not offend Mr. Buckley's well-known views. He would abolish all deductions and exemptions and the graduated rate concept and tax gross income (however little or much) at a flat rate of 15%.

In many instances, Congress has not left an official explanation for deductions or exclusions written into the federal income tax laws. Pechman says,

> "There is no recorded explanation of the justification for many of the personal deductions. Most of them have been allowed since the beginning of the income tax." (p. 81).

Pechman's observations apply as well to exclusions. In cases where no Congressional explanation can be quoted, this report will quote Pechman and the other analysts who have written on what they think Congress had in mind.

ITEMS ADJUSTED OUT OF GROSS INCOME

The Montana income tax law starts its way toward taxable income by adopting the federal concept of adjusted gross income. Simply stated, adjusted gross income as defined by section 62 of the Internal Revenue Code is the gross money income except for the total exclusion of interest on state or municipal bonds and the partial exclusion of capital gains and stock dividends and several other types of income usually earned by corporations rather than individuals. In 1968, individuals had a total money income of $689 billion of which $600 billion was adjusted gross income (Pechman, p. 272).

Municipal bonds

The exclusion of interest on state and muncipal bonds has been provided since the first Internal Revenue Code in 1913; Hellerstein writes:

> "[It] grew out of a Congressional fear that such a tax might be unconstitutional; the legislators thought that the Federal government might be interfering with the sovereign borrowing powers of the states and their local subdivisions by taxing the income on the bonds they issued." (p. 17)

While the constitutional basis of the original rationale no longer exists, if it ever did, the exclusion has long since developed a new reason for being. Local governments, the principal bond issuers, can borrow at lower interest rates, and thus the unpopular property tax can be held down. Pechman points out that municipals are harder to market than corporate bonds, due to the smaller amounts and relative lack of information available to

investors. Thus, without tax exemption, interest on municipals would have to be higher than interest on corporate issues.

While criticizing the provision as an inefficient subsidy (savings to local governments is only half the revenue lost by the federal government), Pechman concludes that abolition of the exclusion would be politically impossible unless the loss to local governments could be compensated (p. 100).

Capital gains

While municipal bond income treatment is straightforward and comprehensible, the treatment of capital gains is a Universe of Finagling. One-half of net capital gains (so much of long-term capital gains realized and recognized in a year as exceeds long-term capital losses realized and recognized that year) is excluded from adjusted gross income, and the other half is taxed at a rate preferential for the higher brackets. While the earliest modern income tax laws taxed recognized capital gains as ordinary income, these gains have been given special treatment since 1921. Here are some of the pros and cons as seen by tax scholars:

Pechman (p. 97) notes that:

> bunching of capital gains in years of realization requires some moderation of the rates or some provision to average them over a period of years. Full taxation of capital gains is also criticized because it might have a substantial "locking-in" effect on investors and reduce the mobility of capital. It is also argued that preferential treatment of capital gains helps stimulate a higher rate of economic growth by increasing the attractiveness of investment generally, and of risky investments in particular.

On the other hand, Pechman says, the bunching problem (where one year's income is much higher than the person's normal income) could be handled by income averaging methods as well as by preferential rates. As to the mobility of capital, he maintains, the

present system locks it in through its nonrealization of gains transferred by gift or inheritance.

Hellerstein (p. 30) notes the state-of-the-economy and bunching arguments and also the justification that the sale of fixed assets such as plant and machinery, land, or securities is not "income" at all.

Against these justifications, he says, from a sociological viewpoint one might justify <u>higher</u> tax rates on capital gains than on earned income. Increases in the value of real estate over the years are due primarily to the community, not the efforts of the individual owner. Likewise, increases in the value of stocks result from general community factors: aircraft and electronics due to the cold war, automobiles and housing and home furnishing industries from government highway programs, subsidies and loans.

Stern cites the bunching and frozen capital justifications and, in rebuttal, argues that the six-month holding period makes a mockery of the bunching argument and the failure to tax gains at death freezes more capital than would taxation of gains as ordinary income. He also notes the justification of encouraging speculative investment in pioneering ventures. However, he contends that as long as people think they can make a profit on stocks, they won't be dissuaded from trying by the fact that they'll have to share a part of those profits with the government (pp. 114-116).

Stern says the capital gains tax provisions are the no. 1 means of tax avoidance. He mentions (p. 96) a study of the "stratospherically rich" families of America, showing the average such family with a total annual dollar intake of $9 million, of which $6 million was capital gains.

Buckley doesn't analyze the justifications, but he proposes sweeping changes, including repeal of the corporate income tax altogether and taxation of capital gains as registered each year.

"Companies that elected to plow profits into development would be required to advise stockholders of their undistributed earnings per share, on which a tax would be due every year." (p. 67) Under a flat-rate tax such as he favors, there is no "bunching" problem.

Stock dividends

A single taxpayer may exclude $100 and a married couple $200 of stock dividends from adjusted gross income. Stern writes:

> The ostensible reason that Congress gives for bestowing tax favors upon the owners of corporation stock is that it eases, to some degree, the extent of "double taxation" that supposedly arises because each dollar of dividends is taxed once when received by the corporation, as part of profits, and a second time when it is received by the individual shareholder in the form of a dividend. (p. 91)

But Stern scoffs at this justification. He calls double taxation a bogeyman, arguing that anyone who buys an automobile tire pays an excise tax with the already taxed dollars of his take-home pay. Multiple taxation is ubiquitous. He also argues that $200 of tax-free income is available in full only to couples wealthy enough to own something over $6,000 worth of stock (p. 90).

Pechman says the equities of the double-taxation issue are a "tricky problem", and that theoretically satisfactory solutions are impractical to administer (pp. 140-148).

DEDUCTIONS FROM ADJUSTED GROSS INCOME

Having reached adjusted gross income, the law now guides the taxpayer through a series of exemptions and deductions to the bottom

line, taxable income. In 1968, that $600 billion of adjusted gross income became $353 billion of taxable income (Pechman, p. 276).

A. First group -- the itemized business or personal deductions

The Montana law allows as deductions "the items referred to in section 161 ... of the Internal Revenue Code ...." These are itemized deductions available to individuals and corporations. Some are of a nature such that they would be used by corporations almost exclusively (such as amortization of pollution control equipment or railroad rolling stock), and those are not examined in this report. Those which might be also often claimed by individual Montanans are sections following sec. 161, as follows:

Sec. 162. Trade or business expense

Sec. 163. Interest

Sec. 164. Taxes

Sec. 170. Charitable contributions

Sec. 175. Soil and water conservation work

Sec. 180. Fertilizer

Sec. 182. Clearing land for farming

<u>Trade or business expense</u>

This long-established deduction has a few applications which have been troublesome, such as travel and entertainment, education necessary to maintain occupational or professional status (but not to learn a new trade), and lobbying (deductible for businessmen, not for charitable contribution givers).

<u>Interest</u>

The next deduction, interest on debts incurred, is used as a business deduction and also as a personal deduction by many wage-

earning taxpayers with mortgaged homes. In the latter application, the deduction is criticized by Pechman:

> The deduction for interest is justifiable when the interest is paid in connection with a loan used to produce taxable income. The interest payment is in fact a negative income, which should be offset against the positive income produced by the asset purchased with the loan proceeds. Alternatively, an individual may prefer to borrow money and pay interest rather than sell an asset; in such cases, the interest deduction is also required to measure the individual's true net property income. However, a substantial proportion of the interest deducted on tax returns is for loans on homes and consumer durables that do not produce taxable income ... Since the rental value of an owner-occupied house is not included in the owner's income, the deduction of expenses -- including interest and taxes -- connected with the house is not warranted. (p. 82)

What warrants the mortgage payment deduction, according to Buckley, is the desire "not to aid mortgage companies, or even the homeowners exclusively, but indirectly to encourage homeownership: that institution of social stability that induces people to sink their roots in a community..." (p. 49)

<u>Taxes</u>

Another part of the original tax code. Pechman writes:

> A deduction for income taxes reduces the combined effect of federal, state, and local income taxes; it is also an effective way of moderating interstate tax differentials in the higher income brackets. For example, if an income were subject to the highest state rate of 14.6 and also to the 70% rate for federal purposes, the combined marginal rate would be 84.6%. By allowing taxpayers to deduct the state tax on their federal returns, the maximum combined rate is reduced to 74.4%. If the state also permits a deduction for federal taxes, the maximum combined rate is 71.5% (p. 83).

The deduction of state income taxes on the federal return allows a state to adopt a graduated rate structure and pass a great deal of the actual burden on to the federal revenue structure. Note, in Pechman's first example, where the combined rate is 74.4% and the state does not allow deduction of the federal tax -- the taxpayer pays 4.4% of the state's total take of 14.6%. "In effect, adoption

of graduated rates offers an opportunity for the state to participate in a form of state-initiated revenue sharing." (Moscovitch, "State Graduated Income Taxes -- A State-Initiated Form of Federal Revenue Sharing", 25 Nat. Tax Journal 53 (1972).

Pechman analyzes the justification for other taxes as follows:

> The deductions for general sales and property taxes survived because it was felt that some federal relief for these taxes was needed to encourage state and local governments to raise needed revenue, without encouraging them to use a particular source. The deduction for gasoline taxes was retained for the same reasons, but here the rationale is strained. (p. 83)

Charitable donations

The obvious rationale here is to encourage taxpayers to support nonprofit organizations doing socially desirable work. The wording of section 170 has grown formidably complex over the years, as Congress has attached conditions to the deduction to carry out its policies toward perpetual foundations, lobbying by nonprofit groups, and occasional use of the deduction as a significant tax avoidance device by the very wealthy. In this last context, the charitable deduction is usually harnessed to a capital gain or loss, as a hypothetical case by Stern illustrates:

> Croesus, a taxpayer in the 70% bracket, donated stock left to him in his grandfather's will to a charity. It was virtually worthless when his grandfather died, but had appreciated to be worth $2 million when Croesus made the gift. "His tax saving was $1,400,000 of income tax resulting from the $2 million deduction, plus the avoidance of $700,000 in capital gains tax -- for a total saving of $2,100,000, or $100,000 more than his $2 million gift." (p. 142)

Soil and water conservation

When the Senate worked on the 1954 Revenue Code, the Finance Committee noted that most farmers' expenditures to improve land were required to be capitalized rather than deducted as current

expenses. The committee cited a decision of the Tax Court going the other way, holding that expenditures for terracing farms may be regarded as maintenance costs and deducted as expenses. To clarify the legal situation, the committee decided to let farmers expense all soil and water conservation expenditures like terracing. S. Rept. 83-1622 (1954), p. 33

Fertilizer

This deduction was enacted in 1960 to affirm what had been standard accounting practice until the IRS began to question it. Explained the Senate Finance Committee:

> For many years it has been the universal practice of farmers to deduct the cost of fertilizer and lime in the year in which it is paid or incurred. Recently, however, ... the IRS has questioned a deduction for lime and fertilizer on the ground that its cost is a capital expense which should be spread over the beneficial life. This is contrary to the long-accepted and widespread practice ....
>
> In order to make certain the intention of Congress that these expenses be treated as business expenses, your committee has added a new section 180 to the Internal Revenue Code .... S. Rept. 86-1767 (1960), p. 13

Clearing land for farming

The Senate added this amendment to the 1962 Revenue Act. The Finance Committee reported:

> At the present time, expenditures made during the preparatory period in extending a farm may not be deducted since they are not expenses incurred in the business of farming. Examples of expenditures of this nature which, under existing law, must be capitalized are expenditures (including materials and labor) incurred in: (1) clearing brush, trees, and stumps, (2) leveling and conditioning land, and (3) straightening creek beds. Because expenditures for these purposes, when incurred in order to make the land suitable for farming (like expenditures for soil conservation), are also closely associated with the trade or business of farming, your committee believes it would be proper to allow their deduction to a limited extent.

B. Second group -- the itemized personal deductions.

The Montana tax law next references for deductions "the items referred to in section ... 211 of the Internal Revenue Code ...." These items are the so-called personal deductions, which would not arise in a business context. With the exception of section 212, and possibly the new 219, they benefit middle to lower income groups proportionately more than they benefit the wealthy. They are, as set out in I.R.C. sec. 211, subsequent sections as follows:

Sec. 212. Expenses for production of non-business income

Sec. 213. Medical and dental expenditures

Sec. 214. Care of certain dependents

Sec. 215. Alimony

Sec. 216. Cooperative housing costs, stockholders

Sec. 217. Moving expenses

Sec. 219. Contributions to individual retirement accounts

<u>Expenses for production of income</u>

The 1954 code preserved existing law which allowed an individual to deduct expenses connected with earning income or managing and maintaining income-producing property. The House tacked on a provision that year allowing deduction of the legal and other costs "in connection with the determination, collection or refund of any tax." No rationale was given. The expenses most often deducted under this section are dues to labor unions or professional societies.

<u>Medical expenses</u>

Pechman says the best rationale which can be adduced for the whole group of personal deductions is that they represent large, unusual, and necessary personal expenditures. Deductions

for extraordinary medical expenses are the best examples of this group. Such expenses are often involuntary and unpredictable and may exhaust a large proportion of the taxpayer's total income in a particular year. When a serious illness strikes a member of the family, its ability to pay taxes is clearly lower than that of another family with the same income whose members are healthy.

A deduction of this type has existed for many years. The 1954 code dropped the threshold from 5% to 3% of adjusted gross income and doubled the maximum from $1,250 to $2,500 per exemption, saying the old limits did not encompass all "extraordinary" medical costs. S. Rept. 83-1622 (1954), p. 35. Special treatment for taxpayers over 65 years old was added in 1958 and 1964, and in the 1965 medicare bill, taxpayers were allowed a separate deduction of one-half the cost of health insurance, up to $150 a year, and repealed the maximum limits. IRS and the Senate Finance Committee opposed the health insurance deduction, saying it could set a bad precedent, but the conference committee left it in. The precedent may be for deduction of other sorts of insurance premiums. Erosion of the tax base, as of the soil, starts with tiny cracks.

Care of certain dependent children

As amended in 1971, this deduction covers expenditures for day care or baby sitting when the taxpayer has no spouse and does not earn over a certain amount. The Senate Finance Committee said:

> This provision should be of assistance both in meeting the unusual household and child care expenses faced by what are essentially one-adult families and at the same time should provide significant employment opportunities for many presently seeking employment. S. Rept. No. 92-437 (1971)

Alimony

Alimony (but not child support) payments have been deductible since the 1942 Revenue Act, when Congress substantially hiked the tax to meet the burdens of World War II. Alimony received is part

of the recipient's taxable income.

Housing coop stockholders

This is a wordy deduction, added in 1962, to create parity between the tenant stockholders in a cooperative housing apartment development and the tenant-stockholders in a cooperative housing development of separate homes.

Moving expenses

This is another recent-vintage deduction, added in 1964 when Congress was concerned with persistent poverty in regions such as Appalachia. The House of Representatives was told by the Ways and Means Committee:

> Your committee believes that it is important to remove deterrents to the mobility of labor. Anything which can be done in this respect should aid in reducing local structural unemployment. (H. Rept. No. 749, 1963)

The committee also noted that under existing law when an employer reimbursed a transferred employee's moving expenses, the amount was excluded from the employee's income since they were incurred in the interest of the employer; this was described as discriminating against new employees and those not reimbursed.

And thus the Revenue Act of 1964 added the moving expenses deduction. While this may serve a national policy of getting the unemployed to move to states where jobs exist, its utility to individual states is not so clear. Since the minimum distance of the move must be 50 miles, the deduction may be taken more frequently in Montana than in densely settled states.

Individual retirement accounts

This deduction was enacted by the Pension Reform Act of 1974

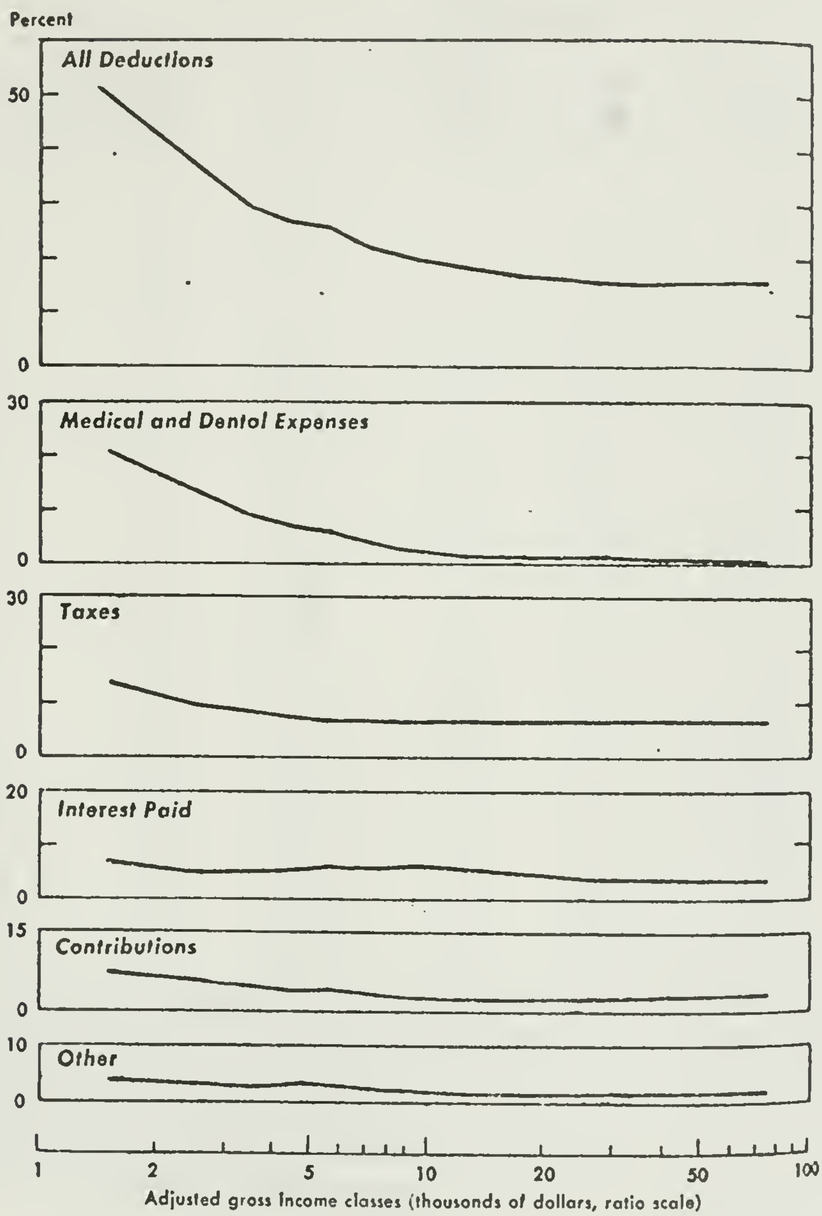
to give self-employed persons equity with those who work for others and whose retirement benefits are not always treated as income.

SOCIO-ECONOMIC PATTERNS OF THE DEDUCTIONS AND EXCLUSIONS

Pechman presents Treasury Department figures indicating that the itemized deductions altogether, and medical expenses in particular, benefit the poor the most (Figure 4-5). The curve is slightly different for the interest paid deduction, indicating that it most benefits taxpayers with adjusted gross income of $10,000 (1968 figures). However, the total effect is striking: at the top of the income scale, itemized deductions amount to less than 20% of adjusted gross income. Yet, stories of the super-rich who avoid all tax are commonplace, and it is generally accepted that the 70% top bracket is a chimera, that 35% is about the highest percentage anyone actually pays.

How do the wealthy bring down their tax liability if not through the itemized deductions? Through the definition of adjusted gross income, it would appear. Capital gains and municipal bonds are the principal means of tax avoidance. Pechman's table C-11 makes this clear: capital gains treatment alone drops the highest bracket from 69.3% to 46.3%.

FIGURE 4-5. Itemized Deductions as a Percentage of Adjusted Gross Income, Taxable and Nontaxable Federal Individual Returns, 1968



Source: U.S. Treasury Department, Internal Revenue Service, *Preliminary Report, Statistics of Income—1968, Individual Income Tax Returns* (1970), p. 31.

TABLE C-11. Influence of Various Provisions on Effective Rates of Federal Individual Income Tax, 1969 Act

(In percentages)

Total income[a] class (dollars)	Nominal tax rate[b]	Reduction due to: Personal exemptions	Deductions[c]	Tax preference items[d]	Capital gains[e]	Maximum tax[f]	Income splitting	Actual tax rate[g]
0– 600	14.0	13.9	—	—	—	—	—	0
600– 1,000	14.4	13.2	1.0	—	—	—	—	0
1,000– 1,500	14.8	11.1	3.6	—	—	—	—	0
1,500– 2,000	15.3	10.1	4.7	—	—	—	—	0.3
2,000– 2,500	15.9	9.8	4.3	—	—	—	—	1.5
2,500– 3,000	16.4	9.5	4.2	—	—	—	—	2.5
3,000– 3,500	16.8	9.2	4.0	—	—	—	—	3.3
3,500– 4,000	17.1	8.5	4.1	—	—	—	—	4.2
4,000– 4,500	17.5	8.3	3.9	—	0.1	—	—	5.0
4,500– 5,000	18.0	8.3	3.8	—	—	—	0.1	5.5
5,000– 6,000	18.5	8.1	3.8	—	0.1	—	0.2	6.2
6,000– 7,000	19.3	7.9	3.7	—	0.1	—	0.4	7.1
7,000– 8,000	20.0	8.1	3.8	—	0.1	—	0.6	7.3
8,000– 9,000	20.8	7.7	4.0	—	0.1	—	0.8	8.1
9,000– 10,000	21.5	7.7	4.3	—	0.1	—	0.9	8.5
10,000– 11,000	22.3	7.2	4.5	—	0.2	—	1.2	9.2
11,000– 12,000	23.1	7.2	4.7	—	0.2	—	1.4	9.6
12,000– 13,000	24.0	7.0	5.0	—	0.2	—	1.6	10.1
13,000– 15,000	25.2	6.7	5.3	—	0.3	—	2.0	10.9
15,000– 20,000	27.9	6.4	6.2	0.1	0.5	—	2.7	11.9
20,000– 25,000	31.9	5.9	7.1	0.2	1.0	—	4.0	13.6
25,000– 50,000	38.8	4.6	8.1	0.6	2.2	—	6.3	16.8
50,000– 75,000	47.6	3.1	8.5	0.7	4.3	0.3	7.2	23.5
75,000– 100,000	52.8	2.2	9.0	1.0	6.8	0.5	6.4	26.7
100,000– 150,000	57.5	1.6	9.7	1.5	9.6	0.5	5.6	28.7
150,000– 200,000	61.2	1.2	9.8	1.6	13.4	0.4	4.8	29.8
200,000– 500,000	64.8	0.7	10.1	1.7	16.6	0.3	3.4	31.8
500,000–1,000,000	67.8	0.3	9.5	2.0	21.1	0.1	1.5	33.1
1,000,000 and over	69.3	0.1	8.4	3.1	23.0	—	0.5	34.0
All income classes	25.4	7.1	5.1	0.2	1.1	h	1.7	10.1

Source: Special tabulation based on a file of about 87,000 federal individual income tax returns for 1966. Calculations are based on rates, exemptions, and other provisions of the Tax Reform Act of 1969 scheduled to apply to calendar year 1973 incomes.

a. Total income is the sum of adjusted gross income, excludable sick pay, excludable dividends, excludable moving expenses, and tax preference items as defined in the Tax Reform Act of 1969, including excluded net long-term capital gains. Preference items were estimated on the basis of diverse sources.

b. Rate schedule for married persons filing separate returns applied to total income.

c. Standard and itemised deductions plus dividend, sick pay, and moving expense exclusions.

d. Special calculation for tax preference items, except excluded net long-term capital gains. The net effect of this category was calculated by eliminating the minimum tax on preference items and including these items in total income to be taxed at the regular rates.

e. Combined effect of the alternative tax calculation for taxpayers with capital gains and excluded net long-term capital gains.

f. Effect of maximum marginal tax rate of 50 percent on earned taxable income.

g. Includes reductions due to retirement and foreign tax credits, which are not shown separately.

h. Less than 0.05 percent.